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HEADLINE: Unhappy Valley: why a high-tech hub is accused of taking the easy option CORPORATE GOVERNANCE: As the SEC gets tough on backdating, technology companies may have to rethink the ways they attract and retain talent, writes Kevin Allison

BYLINE: By KEVIN ALLISON and RICHARD WATERS

DATELINE: SAN FRANCISCO

BODY:

When Christopher Cox, chairman of the Securities and Exchange Commission, flew to San Francisco last week to announce the first charges stemming from the government's investigation into stock options backdating, his choice of venue said as much about the message he was trying to send as the list itself.

Silicon Valley, which lies a short distance to the south, has long been seen as the home of the stock options compensation culture.

"Mr Cox flying across the country sends a sharp message to the Valley that the SEC is serious about backdating and that boards had better pay attention," says Richard Koppes, former general counsel at the California Public Employees' Retirement System, America's biggest pension fund, and a corporate governance specialist.

Silicon Valley boardrooms had already been left reeling by concerns that dozens, if not hundreds, of companies across the country may have improperly manipulated the dates of stock options grants to coincide with low points in the value of their companies' shares.

When Mr Cox and the US attorney in San Francisco took to the podium last week, they struck a further blow at the heart of the options establishment by handing down criminal charges against two of the Valley's own, both former executives of Brocade Communications Systems, a San Jose-based maker of networking equipment (see below).

Although suspected backdating has turned up in investigations across the US, Silicon Valley remains the locus of greatest concern. The serious nature of some of the alleged abuses has re-ignited debate on the quality of corporate governance in the world's leading high-tech hub. By engaging in the apparently widespread practice of options backdating, executives at hundreds of companies may have made improper disclosures or fallen foul of well-established accounting rules.

Lynn Turner, the SEC's chief accountant from 1998 to 2001, says such actions are tantamount to cheating. "It's like allowing people to place bets on a horse race after the horses have crossed the finish line," he says. "In that case, employees are getting something that no other shareholder is able to get. Shareholders can't go out and buy the stock at last week's price."

Stock options have been a symbol of Silicon Valley since the 1990s, when technology companies, faced with fierce competition for talented managers and engineers, pioneered their use as a compensation tool. "During 1998 to 2001, companies were luring away talent from competitors, from other Silicon Valley companies, largely by issuing stock options," says David Yoffie, a professor at Harvard Business School and a member of Intel's board.

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The Valley's burgeoning options culture soon became a model for aspiring technology hotspots around the world. By the time the "new economy" kicked into full gear, stock options had become an expected part of the hiring game, with prospective employees ever more sensitive to their options' exercise prices.

Evidence that has come to light in some of the backdating cases suggests that this booming options culture had a darker side. It now appears that at least some of the companies that showered options on their employees during the boom did so with a disregard for the niceties of accounting and corporate governance.

"If companies had money to spend, they were spending it on innovation," explains David Larcker, a professor at Stanford's Graduate School of Business. "They were spending a minimum on compliance and ticking the boxes."

Defenders of stock options insist that backdating was a well-intentioned if careless practice used not to steal from shareholders but to benefit them by ensuring that fast-growing but cash-strapped companies could hire and retain the best managers.

Some say shareholders gave their tacit approval to such practices as they watched paper fortunes accumulate during a period of unprecedented share price growth. "There was an implicit understanding between investors and companies that these were extraordinary times requiring extraordinary measures," says Roger McNamee, co-founder of Elevation Partners and a veteran Silicon Valley financier.

Charles Elson, director of the John L. Weinberg Center for Corporate Governance at the University of Delaware Business School, says the lack of control that allowed backdating to become rife was part and parcel of the broader corporate culture.

"For a long time, the view of companies in the Valley was that they were better than the rest, that they were companies that needed to move at internet speed and have internet-speed governance," he says. "There was a view that governance only applied to old, large companies with problems. Accountability was missing because of the rather cavalier attitude of these businesses, and now the chickens have come home to roost."

Wall street internet analysts took the heat in the regulatory backlash that followed the dotcom bust in 2000. Some paid hefty fines and were barred from the securities industry for life for making bogus recommendations. But the reputation of Silicon Valley - home to so many of the companies that imploded in the post-bubble shake-out, resulting in billions of dollars in losses - remained largely unscathed.

Gradually, a new regulatory environment started to press in. The collapse of Enron and WorldCom ushered in a new era of tighter accounting controls, first through the Sarbanes-Oxley act and more recently through accounting rules that require companies to account for the cost of stock options in their profit-and-loss statements.

Swimming against the tide, Valley companies spent the years following the bust arguing that all of this was unnecessary - and worse, that it would destroy US innovation. Sarbanes-Oxley, they claimed, imposed big costs on small companies, while expensing would kill off stock options and cripple innovation.

These are familiar arguments in the Valley. "Going back to the mid-Nineties, they had the 'Rally in the Valley', with marching bands and people running up and down the streets, holding a pep rally against the (Federal Accounting Standards Board)," says Patrick McGurn, special counsel at Institutional Shareholders Service, a company that represents institutional investors at shareholder meetings. "There were a lot of entrepreneurs making a strong case that if the accounting changed it was going to destroy the engine of growth in the US economy."

Many of the companies where alleged improper backdating took place were enthusiastic cheerleaders of the Valley's attempts to lobby against more rigorous options accounting. The hypocrisy of this stance is now being exposed.

"If you go back and look at what technology companies were saying during the argument over options expensing, they said the current options expensing standards were fine, so don't make us go to the new ones," says Mr Turner, the former SEC chief accountant. "In reality, they weren't even following the existing standards. It was something less than genuine."

In one case, Amnon Landan, the former chief executive of Mercury Interactive, a business software company, complained in an interview with the FT in 2003 that the company risked shareholders becoming "too conservative" in their efforts to curb the use of stock options as a compensation tool.

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Mr Landan resigned last November amid revelations that he and other Mercury executives were aware of, and had benefited personally from, favourable backdating of stock options grants. Mercury's shares were de-listed from the Nasdaq after improper accounting of the backdated options forced it to restate several years' worth of earnings reports.

The full impact of the backdating scandal on Silicon Valley is not yet known. But things do not look good. More than 80 companies have been caught up in the government investigation into backdating so far. Mr Cox has vowed to put the "full weight" of the federal government behind efforts to stamp out the practice.

"I think before it is all said and done we are going to have several hundred companies implicated in this," says Robert Willens, an accounting analyst at Lehman Brothers.

For now, truly egregious cases of abuse appear few and far between. Nevertheless, defenders and critics alike acknowledge that Silicon Valley's governance culture is set for a shake-up.

Prof Elson at the University of Delaware believes companies in the Valley will come under pressure from shareholders to abandon stock options in favour of grants of restricted stock, which provide similar incentives to those of stock options but have less potential for abuse.

Mr Turner, the former SEC chief accountant, says regulators may lack the capacity to tackle hundreds of cases of alleged wrongdoing. "They can focus on the most egregious cases, and they should," he says. "The SEC should make an offer of clemency to companies who self-investigate and self-report."

Mr Turner cautions that a lack of follow-through could leave the door open to further abuse. Others fear the opposite. Mr McNamee at Elevation Partners says that serious problems with options backdating are likely to remain limited to a few bad apples. The real danger, he argues, is that politically motivated regulators will use the controversy to institute new rules that hurt growth companies.

"Part of this is scapegoating, and part of it involves real issues," he says. "I believe we live in a time that is anti-growth. It has become politically attractive to go after things like this."

He says the attack on backdating will further weaken the use of options in the US. "We are absolutely moving away from that," he says. "I think it will hurt."

Additional reporting by Richard Waters

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